Employment Development Department
State of California

INFORMATION SHEET

STOCK OPTIONS

What Are Employee Stock Options?

An employee stock option is the right or privilege granted by a corporation to an employee to purchase the corporation's stock at a specified price during a specified period.

Those stock option plans that meet the requirements of Sections 421 through 424 of the Internal Revenue Code (IRC) are referred to as *statutory* stock options; those that do not are referred to as *Nonstatutory* (or nonqualified) stock options (NSO).

Statutory stock options consist of incentive stock options (ISO) and employee stock purchase plans (ESPP).

Determinations as to whether the specific provisions of an employer's stock option plan meet the requirements of the IRC will be made by the Internal Revenue Service (IRS).

In addition to these stock options, there is also a California qualified stock option, which meets the requirements of Revenue and Taxation Code (R&TC) Section 17502.

The following discussion further defines the various types of stock options and provides a detailed explanation of the California employment tax treatment of income derived from stock options. Following this narrative delineation, a one-page summary grid is provided for easy reference.

Incentive Stock Options (ISO)

An incentive stock option must meet the specific requirements of IRC Section 422. The tax treatment of an ISO depends, in part, upon when the employee disposes of (i.e., sells, exchanges, gifts, or transfers) the stock.

An ISO sold after a required minimum holding period is said to have a "qualifying disposition." Those not held for this period are said to have a "disqualifying disposition."

When an ISO is exercised, regardless of the disposition, the "spread income" i.e., the difference between the fair market value (FMV) of the stock on the date exercised and the cost of the stock to the employee, is subject wages for Unemployment Insurance (UI), Employment Training Tax (ETT), and State Disability Insurance (SDI). If the ISO ultimately has a <u>qualifying</u> disposition, the spread income is not subject to California Personal Income Tax (PIT) withholding and is not reportable as PIT wages.

The spread income from an ISO having a <u>disqualifying</u> disposition is subject to PIT withholding when disposed and is reportable as PIT wages. Any additional gain (defined as the FMV of the stock on the date exercised less the price at which the employee sells the stock) realized upon the sale of the stock is treated as a capital gain.

Employee Stock Purchase Plans (ESPP)

An ESPP, also referred to as purchase plan option, is a stock option intended for rank and file employees (whereas ISOs are usually intended for "key" employees).

ESPPs must meet the requirements of IRC Section 423; those plans that do not meet these requirements are treated as NSOs.

Employees exercising their options under an ESPP are required to retain the stock for a minimum holding period to have a qualifying disposition. Stock sold pursuant to an ESPP that was not retained for the minimum period is said to have a disqualifying disposition.

Employee stock purchase plans may be granted with an option price below the full FMV of the stock as of the date granted (this discount may not exceed 15%).

When an ESPP is exercised, regardless of whether it ultimately has a qualifying or disqualifying disposition, the spread income constitutes subject wages for UI, ETT, and SDI purposes. If the ESPP has a qualifying disposition, the spread income is not subject to PIT withholding. If the disposition was disqualifying, the spread income is subject to PIT withholding.

If the ESPP was issued at a discount, then regardless of the disposition, PIT withholding and the reporting of PIT wages is required on the lesser of:

- The FMV of the stock at the time of disposition less the amount the employee paid for the stock.

or

- The FMV of the stock at the time granted less the amount the employee paid for the stock.

Any additional gain realized upon the disposition of an ESPP is treated as a capital gain.

Nonstatutory Stock Options (NSO)

An NSO is an employee stock option that does not meet the requirements of IRC Sections 421-424 and does not therefore enjoy a favorable tax treatment.

When an NSO is subject to tax depends upon whether or not, at the time the option is granted, the stock has a readily ascertainable FMV. Whether an NSO has a readily ascertainable FMV is determined by IRC Section 83 and corresponding federal regulations. Most NSOs do not have a readily ascertainable FMV at the time they are granted.

The spread income resulting from an NSO that is granted with a readily ascertainable FMV is wages subject to UI, ETT, SDI, and PIT withholding at the time the option is granted and is reportable as PIT wages.

The spread income resulting from an NSO that does not have a readily ascertainable FMV at the time it is granted is wages subject to UI, ETT, SDI, and PIT withholding at the time the option is exercised and is reportable as PIT wages.

California Qualified Stock Option

Section 17502 of the R&TC provides that a stock option specifically designated as a California qualified stock option will receive the favorable tax treatment provided by IRC Section 421 if all of the following conditions are met:

1. The option is issued on or after January 1, 1997, and before January 1, 2002.

2. The earned income of the employee to whom the option is issued does not exceed $40,000 in the tax year in which the option is issued.

3. The number of shares of stock granted in the option does not exceed 1,000 and the value of the shares does not exceed $100,000.

4. The employee must be employed by the company at the time the option is granted, or must have been employed within three months (one year if permanently disabled) of the date the option is granted.

The provisions of R&TC Section 17502 are applicable only for PIT purposes; for UI/SDI/ETT purposes, the treatment of stock options depends on whether the option is an ISO, an ESPP, or an NSO, as discussed previously.

For PIT purposes, a California qualified stock option is subject to withholding and is reportable as PIT wages upon disposition.

Multistate Jurisdictional Issues

Stock options, as noted in the foregoing, may not immediately become wages subject to taxation. An employee may be granted an option in one state, exercise the option in a second state, and sell the stock in a third.

For UI, SDI, and ETT purposes, wages derived from a stock option are subject to the jurisdiction of the state in which services are otherwise subject, at the time the wages are *paid* (when the option becomes taxable).

For PIT purposes, wages derived from stock options are allocated between the states in which the employee performs services for the employer granting the option. This allocation begins when the option is granted and ends when the income derived becomes *taxable* and therefore *wages* subject to witholding.

Example: A California employee is granted an ISO. The employee works for six months in California subsequent to the granting of the option and then moves to Arizona where she works for six months and then exercises the option and disposes of the stock.

This is an ISO with a disqualifying disposition (not held for the required period). For UI, SDI, and ETT purposes, the spread income at exercise <u>does not</u> constitute wages subject to California's jurisdiction because when the wages were paid (when the option became taxable), the employee was not subject to California pursuant to California Unemployment Insurance Code (CUIC) Sections 602 and 603.

For PIT purposes, the spread income is wages upon the disqualifying disposition and is allocated 50% to California and 50% to Arizona, based on the time worked in each state from the date the option was granted to the date the stock is disposed.

<u>Example</u>: An employee is granted an ISO for services performed in California employment. The employee subsequently is transferred to Florida, where she exercises the option and disposes of it with a qualifying disposition.

In this case, the spread income is <u>not subject</u> to California for UI, ETT, SDI or PIT. This is because the employee's services were localized in Florida when the option became taxable wages and ISOs with a qualifying disposition are not subject wages for PIT withholding purposes.

<u>Example</u>: An employee is granted an NSO (without a readily ascertainable FMV) for services performed in California employment. The employee retires and moves to Nevada, where he exercises his option. In this case, the spread income is subject to California for UI, ETT, DI, and PIT withholding and is reportable as PIT wages.

In this instance, the wages are subject to California for UI, SDI, and ETT purposes because services were localized in California. Similarly, for PIT purposes, because all of the employee's services were performed in California, the income (and the tax thereon) is allocated exclusively to California.

Additional Information

With the exception of California qualified stock options, California's employment tax treatment of stock options conforms to the federal employment tax treatment, which has evolved through court decisions and IRS rulings.

Public Law 104-95, which precludes states from taxing the retirement income of non-residents, is not applicable to stock options.

CUIC Section 13028, which details withholding provisions applicable to pensions, annuities, and other deferred income, is not applicable to stock options.

Questions specific to stock options that are not addressed in this general information sheet should be directed to:

State of California
Employment Development Department
FACD Central Operations, MIC 94
10969 Trade Center Drive, Suite 203
Rancho Cordova, CA 95670-6140
(916) 464-2500

Attached is a matrix that provides a quick visual reference to the California employment tax treatment of stock options.

Employment Tax Treatment of Stock Options

Type of Stock Option	Federal Withholding	FICA	FUTA	UI/ETT/DI	PIT Withholding	PIT Wages
	Federal Tax Treatment			**California Tax Treatment**		
Incentive Stock Option (ISO)						
Qualifying Disposition	Not subject [1]	Subject when exercised [2]	Subject when exercised [2]	Subject when exercised	Not subject	Not reportable
Disqualifying Disposition	Subject when disposed [2]	Subject when exercised [2]	Subject when exercised [2]	Subject when exercised	Subject when disposed	Reportable when disposed
Employee Stock Purchase Plan (ESPP)						
Qualifying Disposition	Not subject [1,3]	Subject when exercised [2]	Subject when exercised [2]	Subject when exercised	Not subject	Not reportable
Disqualifying Disposition	Subject when disposed [2]	Subject when exercised [2]	Subject when exercised [2]	Subject when exercised	Subject when disposed	Reportable when disposed
Nonstatutory Stock Option (NSO)						
With Readily Ascertainable Fair Market Value When Granted	Subject when granted [4,5]	Subject when granted [4,5]	Subject when granted [4,5]	Subject when granted	Subject when granted	Reportable when granted
Without Readily Ascertainable Fair Market Value When Granted	Subject when exercised [6]	Subject when exercised [6]	Subject when exercised [6]	Subject when exercised	Subject when exercised	Reportable when exercised
California Qualified Stock Option	N/A	N/A	N/A	Depends on type of option	Subject when disposed	Reportable when disposed

[1] IRC 421(a), FTR 14a.422A-1
[2] *Sun Microsystems, Inc. v. Commissioner*, TC 1995-69 and IRS Acquiescence
[3] IRS Private Letter Ruling (PLR) 9407013
[4] IRC 83(a)
[5] Rev. Ruling 67-257
[6] IRC 83(e)(3), FTR 1.83-7(a)